

PREMIER PENSIONS MANAGEMENT

TECHNICAL UPDATE: 13/08

Setting of Technical Provisions

Pensions Act 2004

Many Trustees and Sponsoring Employers established their Technical Provisions based on the yield available from “AA rated bonds”.

This followed the introduction of the Pensions Act 2004 which required the Trustees to set Technical Provisions on a “prudent basis”. Many plans retained a significant proportion of assets in equities (expected to provide a higher return than gilts and corporate bonds). Hence, assuming investment returns based on AA rated bonds retained some margins against the higher expected long term investment returns from the equities held within the Plan – ie there was a clear margin over best estimate to demonstrate prudence.

A further factor in this decision was the use of this approach towards pension obligations in Company Accounts where there is a requirement to set up proper and prudent provision for any liabilities.

Developments in the last 12 months

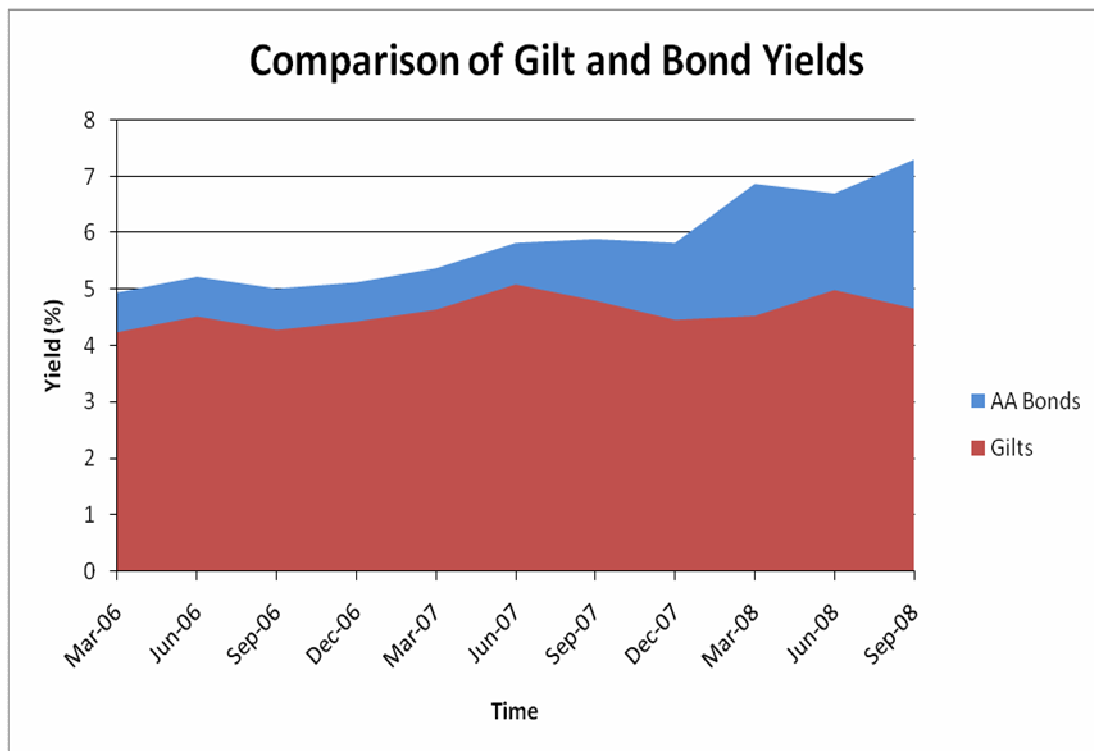
Historically, AA rated bonds have provided yields around 0.75% - 1.0% per annum in excess of Government Securities. Adopting the above approach for funding was reasonable and prudent when the difference in yields remained at this level – particularly as equity investments may be expected to provide an investment return 3.0% - 3.5% above that available from Government Securities.

The difference in yields had remained at around 0.75% until around September 2007. Since that time it had increased significantly to in excess of 2.5% per annum at September 2008.

The impact of this increase means that the value placed on the liabilities (ie. the Technical Provisions) has reduced by in excess of 30% in the last 12 months although the liabilities themselves have not changed. In effect, the Plan is now expecting a significantly higher investment return in future and hence fewer assets are currently needed to meet the liabilities.

Comparison of Yields on Government Securities and AA Bonds

	Market Yields		
	AA Rated Bonds	Government Securities	Difference
	(% pa)	(% pa)	(% pa)
5 April 2006	4.94	4.23	0.71
30 June 2006	5.22	4.51	0.71
30 September 2006	5.01	4.27	0.74
31 December 2006	5.12	4.42	0.70
31 March 2007	5.37	4.63	0.74
30 June 2007	5.82	5.08	0.74
30 September 2007	5.89	4.79	1.10
31 December 2007	5.82	4.45	1.37
31 March 2008	6.87	4.52	2.35
30 June 2008	6.70	4.98	1.72
30 September 2008	7.30	4.65	2.65



Issues to Consider

The Trustees and Employer need to consider whether the current approach to setting Technical Provisions (based on AA rated bonds) remains sufficiently prudent and is likely to continue to do so following the next valuation. As the difference in yields (above) has increased the margin over equity returns has been significantly eroded – which means that the level of prudence in the basis has been significantly reduced.

The Trustees and Employer may also need to consider a revised or further funding objective which would increase the Technical Provisions and restore some of the margins originally envisaged when the basis was set.

One option would be to restrict the assumed future investment return to a maximum of 1.0% - 1.5% per annum in excess of the yield on Government Securities. This would have had no impact on the Technical Provisions up to September 2007 – although from that date forward the Technical Provisions would have been higher and would have retained a higher level of prudence.

Practical Solutions

Changing the basis for the Technical Provisions and the Contribution Schedule requires negotiation with the Employer and will take some time to implement. One practical solution would be to monitor the funding position on a quarterly basis comparing the Technical Provisions with the position if the investment return was set to 'gilts + 1% per annum'. The impact of the changes to AA bond yields could then be clearly identified now rather than waiting for the next valuation.

Most of the information required to do this can be obtained from the valuation report and hence can be done quickly and easily without incurring significant cost.

Premier Pensions has already successfully implemented this process for some clients in conjunction with regular quarterly monitoring – which means that the basis for setting the Technical Provisions at the next valuation is already being considered.

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This update includes general information and cannot be relied upon for individual schemes issues. You should contact your adviser or Paul Couchman at Premier Pensions Management Ltd, Capital Business Centre, Units 14 & 15, 22 Carlton Road, South Croydon, Surrey, CR2 0BS. DL: 020 8916 2129. Email:

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